INVESTNEWS

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ECB QE
Investment managers and economists comments

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RUSSELL INVESTMENTS
A really thick layer of icing on an already attractive cake

According to **Wouter Sturkenboom, Strategist, Russell Investments London**,
"Today's announcement from the ECB qualifies as a QE bazooka. The initial response from financial markets is largely in line with expectations with the euro falling and eurozone financial assets rallying. This is expected to continue for a while.

The one area of surprise is the drop in core yields, which fell alongside their peripheral counterparts. Over time, we expect higher inflation expectations and reduced safe haven demand will push yields 10-20bps higher, although we are conscious that the incremental demand from the ECB might overwhelm supply and keep rates low.

For the attractiveness of eurozone financial assets, this move is the equivalent of a really thick layer of icing on an already attractive cake. We expect it to have a positive impact on eurozone equities, credits and peripheral bonds, while lowering the euro exchange rate.

From the announcement there are two things that are unclear. Firstly, there is no clear breakdown between asset class purchases. Draghi did however state that they were facing difficulties with their ABS purchase program, thereby implying the program will likely be heavily tilted towards government bonds. Secondly, maturity is unclear with Draghi only stating they will buy in the 2-30 year spectrum and will not avoid assets with a negative yield. In terms of risk sharing, 80% of the purchases will remain on national central bank balance sheets and 20% will end up on the ECB's balance sheet. This is a concession to Germany that Draghi was willing to make because he does not think it is of meaningful importance. We think he is right, although the signaling effect is still a small worry."

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SCHRODERS

QE to provide welcome eurozone boost

Azad ZanganA, Europe Economist

"European Central Bank (ECB) President Mario Draghi has announced that the central bank will purchase sovereign debt along with agency debt in order to combat the rising risk of deflation. Despite considerable doubts from Germany, the ECB will follow in the steps of the Federal Reserve, Bank of Japan and Bank of England by introducing quantitative easing (QE) - expanding its balance sheet in an attempt to weaken the euro and raise domestic demand.

Draghi announced that the new additional purchases combined with the existing asset backed securities (ABS) and covered bond purchases will total €60 billion per month starting from March until September 2016 - totalling €1.1 trillion (11% of GDP), or roughly what is required to take the ECB's balance sheet back to the peaks seen in 2012. This is about twice the size expected by the market consensus and as a result, the euro is trading lower against the US dollar and sterling, while European government bonds are seeing falling yields (rising prices).

Eurozone inflation fell below zero in December and is very likely to fall further in coming months thanks to falling energy prices. While we see this as a positive development for growth and medium-term inflation, in the near-term at least, there is a risk that households' inflation expectations become de-anchored and they start behaving in a more deflationary manner. If households start to believe that prices will continue to fall, they may be tempted to hold back spending to achieve lower prices, which in turn will push prices down further thanks to the lower demand. This would reinforce the lower price expectations, and cause a downward spiral in prices – Japanese style deflation. This is not our central view, and today's action from the ECB further reduces the risk of deflation.

The obvious question is will QE make a difference, especially as government bond yields in Europe are already so low? There is certainly scope for bond yields in peripheral Europe to fall further, and for those lower interest rates to feed through to the real economy via the banking system, however, we feel that the main impact will come through from the weaker euro, which will make European exporters more competitive internationally.

The issue of risk sharing in the event of losses was also answered today. Germany appears to have been against the idea of any risk sharing should an issuer look to default on the bonds purchased, but markets were concerned that without risk sharing, the programme would lose any credibility. In the end, the ECB has decided to share the risk on 20% of the purchases, with the remaining covered by individual central banks.

Importantly, the ECB has stated that it will only purchase investment grade debt, with an option to buy the debt issued by lower rated sovereigns for those in a bailout programme. This covers the ECB should the Greek election this weekend result in a government that seeks to end Greece's bail-out programme. Finally, the ECB announced that it would stand equal with private investors should losses be incurred (pari passu), which reduces the incentive of forced restructuring.

Overall, we think the ECB's QE programme will benefit the Eurozone economy by reducing the risk of deflation; however, it is not a panacea for the monetary union's ills. Deep structural reforms are required in order to raise Europe's potential trend growth. Without structural reforms, the ECB may be forced to add additional stimulus in the future as growth falters again."

Rory Bateman, Head of European Equity strategy

"The ECB confirmed today it will embark on investment grade QE at €60 billion per month until at least September 2016 and will continue until inflation moves towards 2%. This is greater than market expectations and represents a significant event for Europe, reflecting Mario Draghi's concern about price deflation across the eurozone which has been exacerbated by the weaker oil price.

The issue of 'mutualisation' (i.e. the ECB taking the loss in the event of debt default rather than national governments) was dismissed by Draghi as an irrelevance as it would not impact the effectiveness of the programme. We would agree that explicit risk sharing is highly unlikely given the imminent Greek elections and take this QE at face value as an extreme monetary stimulus for the region.

Whilst the detail is still emerging, we believe Draghi's announcement is positive for asset prices in Europe and particularly for European equities. Equity markets have performed well during QE in other countries around the world and Europe is likely to follow. We have already seen euro weakness versus other currencies which may well continue given today's release. This will be beneficial for European exporters and when combined with a lower oil price and the resultant impact on consumer spending should ensure upward pressure on corporate earnings during 2015.

We have said on previous occasions that monetary policy in isolation will be insufficient to transform the European growth outlook but this announcement is in our view a significant incremental positive. We continue to believe the economic recovery will be slow and bumpy in the eurozone, but the equity market offers decent upside given attractive valuations relative to other markets and alternative asset classes, as well as a more favourable outlook for corporate earnings given the currency tailwind, lower oil price and a normalisation of the banking sector."
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LEGG MASON
Acting now could turn to be problematic

Andrew Belshaw, Head of Investments, Western Asset à Londres

"Despite the negative impact on the Eurozone's near term inflation outlook from the tumbling oil price, in our opinion, data has not been weak enough to move the ECB away from its 'wait and see' stance until now. Acting now could turn out to be problematic because of the proximity of the Greek elections.
Nonetheless, with the market pricing in QE, President Draghi's hand has effectively been forced. Given the market fallout when Draghi has previously disappointed (back in October 2014) the pressure was on the ECB to do something, and they have delivered, and markets are reacting positively as a result. While the headline figure is €60bn, this includes the existing ABS and Covered Bond program. The reality is the additional sovereign purchases announced today will be of circa €50bn. The fact President Draghi emphasised they would continue until a sustained adjustment in the path of inflation is seen, is clearly positive for the market. The fact inflation linked securities are also included in the purchase program is also positive, reinforcing the ECB's determination to increase inflation expectations.
However, in our opinion, QE is ultimately not the solution to resolve the dual issues of weak growth and fragility which plague the Eurozone. Instead, the ECB should be more radical via its policy operation, perhaps by using its own balance sheet as a backstop to corporate lending.
QE is but one stage on the road to that conclusion, and we expect to see further accommodative policy at some point.

Regina Borromeo, Brandywine Global, London:

"We have been expecting the ECB to announce an expanded asset purchase program since the current programs (Target LTRO/Covered bond purchases and the ABS programs) have not been large enough. These latest measures should help the ECB move towards its goal of price stability.

"Essentially, President Draghi needed to fire a bazooka to increase the ECBs balance sheet and fight deflation, and now politicians need to implement structural reforms."

Michael Browne, *European Absolute Alpha Fund*, Martin Currie, London

“The asset purchase programme is larger than we expected and lasting until September 2016 slightly longer than we thought - this is all good however response from the market has been muted. But 80% of the risk of this initiative sits with the national central banks and not with the ECB and thus the mutualisation of debt is not happening, as Draghi wished. The long term flattening of the yield curve is bad for bank earnings and that is not good for credit growth and that is not good for the recovery. But this Q/E is good for real asset prices, such as equities.

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FIDELITY Worldwide Investment

David Simner, Gérant obligataire Europe

« Un tel programme de rachat d’actifs va maintenir les taux européens particulièrement bas alors que les nouvelles émissions devraient rester faibles en taille. C’est un environnement particulièrement positif pour le crédit Investment Grade et cela se transmettra également au High Yield européen. »

Paras Anand, Directeur des investissements actions européennes, Fidelity Worldwide Investment

« La politique accommodante de la BCE ne doit pas faire oublier que des réformes cruciales et difficiles doivent être mises en place en Europe, particulièrement en France et en Italie. Il faudra libérer les forces vives d’un marché du travail disposant d’un capital humain particulièrement qualifié. La compétitivité de ces pays passera par ces réformes clefs et la politique de QE de la BCE n’aura qu’un impact réduit sur la mise en place indispensable de ces réformes. »

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BLACKROCK

Scott Thiel, Head of the Global Bond Team and Co-Manager of BGF Fixed Income Global Opportunities Fund (FIGO).

“ Today the Governing Council of the ECB did not make any changes to the main refi rate or to the deposit and marginal lending facilities rates but did announce new plans to further loosen its monetary policy stance through an expanded asset purchase programme, otherwise known as quantitative easing (QE).

In the press conference, ECB President Draghi announced that the new QE programme will amount to €60bn per month, including the existing ABS and covered bond purchase programmes, until the end of September 2016 or such time as inflation gets back on track to achieve the ECB's target of close to but below 2%.

From March the ECB will now buy euro-denominated investment grade rated securities issued by eurozone governments and agencies, based on each national central bank's share of capital in the ECB's capital key. This will comprise government bond purchases of approximately €40bn per month or €660bn in total.

Draghi did, however, note that additional criteria would be taken into account for those eurozone countries that are currently in a special EU/ IMF programme. Cross-country risk sharing will only apply to purchases of bonds from a European institution or securities held by the ECB's own balance sheet, not that of the national central banks.

Furthermore, Draghi announced a change to the pricing of the remaining targeted longer-term refinancing operations (TLTROs). The interest rate on these instruments will now be set to the prevailing main refi rate.

In his speech today Draghi also formally welcomed Lithuania as the 19th member of the eurozone, effective from the start of this year.

Market reaction to the news has initially been very positive with peripheral bonds tightening materially and the euro weakening by more than 1%[1].

Ahead of today's announcement, the market was clearly expecting some form of QE to be announced. However, the magnitude of the program was a surprise with the size of the sovereign bond program larger than the expectations of €500bn.

In terms of positioning, we maintain our modest positions in higher yielding peripheral Europe as the sheer size of the ECB QE program will continue to compress yield spreads across eurozone issuers. In the coming days we will evaluate our yield curve flattening bias in light of the potential success of the ECB's new programme.

Today's announcements should be positive for European banks and, as such, we retain our long-standing preference for being overweight subordinated core European bank debt.

At the outset of 2015 we noted that monetary policy will be a key source of volatility in the bond markets. The ECB closes a week of surprise central bank moves.

On 15th January of the Swiss National Bank (SNB) removed its 1.20 EURCHF currency floor and simultaneously cut the deposit rate cut -0.75%. Given the SNB's previous public communications concerning its commitment to the currency floor, the market reacted with a sharp and unprecedented CHF appreciation, with an intra-day move against the euro of almost 30% (down to 0.85) before closing at around 1.05[2].

Earlier in the week, the BoE minutes revealed that the full committee voted to keep rates on hold, with the more hawkish members pushed to neutrality by the fall in energy prices. We still believe that the BoE will raise rates in 2015, compared to the market which is now pricing for the first rate rise in 2016. As such, our positioning in UK rates is still one of short duration. The timing between the first rate hikes from the Bank of England and US Federal Reserve will, in our view, be close as the fundamentals remain on a positive trajectory in both economies. However, it is now most likely that the Fed will move first.

Now bond markets will turn to the US policy decision next week and, in particular, how the FOMC will view the fall in energy prices.

Regarding Japan, although recently reduced in size, we remain positioned for a flatter Japanese government bond curve and we remain short the yen.

Overall volatility has increased in bond and currency markets over the last few weeks and we see the potential for further volatility as liquidity issues arise once markets begin to focus on the large imbalances and crowding in certain sectors that formed during the protracted era of very loose monetary policy and when the divergence of monetary policies does become more pronounced.

In such an environment of raised volatility we believe that maintaining a focus on fundamentals through the noise will be key, along with diversification and a strong focus on risk management.

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STATE STREET GLOBAL ADVISORS

Bill Street, Head of EMEA Investments

"Mario Draghi and the European Central Bank have proved yet again to be willing to employ unconventional measures in an effort to regenerate Europe. The ECB today announced a significant asset purchase programme at the higher end of market expectations in terms of size with EUR 60bn of asset purchases per month. Sovereign purchases will start in March and run until September 2016, split across members. Mario Draghi also advised that the ECB will continue the programme until a sustained adjustment in the path of inflation is seen, leaving it slightly more open-ended than perhaps consensus expected. We expect this to have a positive effect on risky assets, drive further weakening of the EUR and support lower bond yields in both the core and periphery of the Euro area.

"2015 is a pivotal year for Europe, and Mario Draghi has fought claims of illegality and pressures from the ECB's governing council members to get to this point. We must reflect on how much has been done already, as this is the third leg of a comprehensive purchase plan. In 2009 the ECB began to target covered bonds, in an effort to regenerate the mortgage market, and in 2014 the asset backed securities purchase programme was established to address Eurozone's funding mechanism and release bank dependency for SMEs. Now, in 2015, the ECB have turned to quantitative easing, in a bid to alter the discount curve.

“It is crucial that national governments act with similar strength and fulfil their role in doing ‘whatever it takes’ to help Europe. Draghi has consistently made the point that monetary policy can only go so far. It needs to be coupled with structural reform and the liberalisation of labour markets across Europe to be a true success. Patience is running thin for laggards in the reform process.”
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DEUTSCHE AWM

ECB : beyond expectations

Johannes Müller, Head of Investments:

La décision prise aujourd’hui par la BCE va au-delà des attentes du marché. Néanmoins, une fois l’excitation initiale passée, il sera nécessaire de garder la tête froide et d’éviter la spéculation de ces derniers jours.

Le programme de rachat de la BCE ne sera ni une panacée, ni un poison. Son effet positif durable devrait venir de la dévaluation de l’euro, même si dans son ensemble, son impact restera limité.

Nous sommes plus préoccupés par la teneur des discussions en amont de cette décision. Des personnalités politiques ont pris pour acquis - et ont commenté - une décision que la BCE, pourtant indépendante, n’avait pas encore acté.

Quant à l’euro, une pause pourra se marquer, mais nous attendons une dépréciation continue face au dollar. Ceci soutiendra les profits des entreprises de la zone euro et aura un impact positif sur les marchés action. Quant au marché obligataire, puisque nous n’anticipons pas d’inflexion dans la tendance de l’inflation, les rendements devraient se maintenir sur le court-terme.
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UBS

“We take a first look at today's European Central Bank (ECB) press conference and the historic announcement of a EUR 1.1 trillion (trn) quantitative easing (QE) program from March 2015 to September 2016 (at least). We will follow up with a full analysis in due course.

- The new QE program consists of a portfolio of bonds (ABS, covered bonds, sovereign bonds and agencies), and grants investors pari passu treatment (in line with market expectations). The addition of sovereign bonds enables the Eurosystem's balance sheet to exceed the peak in early 2012.
- Consensus expected the balance sheet to expand by EUR 1 trillion to EUR 3 trillion by the end of 2016. As such, the purchase volume target of EUR 1.1trn and the intent to

do more if needed is positive and above consensus expectations as it permits the Eurosystem's balance sheet to expand to somewhat more than EUR 3 trillion at a faster pace.

- The fact that the risk is mostly allocated to national central banks should not derail the QE program's effectiveness.
- The new QE program is large enough to bring about an easing of financial conditions and to create significant wealth effects. Due to the lag in monetary policy, the bulk of the economic impact is only expected from 2016. Yet, past ECB measures, coupled with the falls in the euro and oil prices, should generate a strong growth impulse during 2015."

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NATIXIS
ECB QE: Let's get this party started!

The ECB decided to expand its current purchase programmes to investment-grade Euro area governments, agency and EU institution securities (with maturity from 2 to 30 years). Combined monthly purchases will be €60 billion (including existing purchase programmes for ABS and covered bonds), start in March 2015 and be carried out at least until end-Sept 2016. Over the medium term, purchases would be carried out until sustained adjustment in inflation path consistent with aim of inflation close to, but below 2% over the medium term. For more details on the programme, please refer to the table below.
When will purchases start? March 2015

Which assets? Sovereign bonds, EU institution, agencies

Eligibility criteria? Investment grade securities or additonal criteria for programme countries (Greece, Cyprus)

Size? combined EUR 60 bn per month, covered bond purchases and ABS encompassing; minimum size EUR 1.14 trn in total

Upper limit? 33% per issuer, 25% per issue

What proportions? ECB capital key

Risk-sharing? Risk sharing for purchases of EU institution bonds (12% of additonal purchases*); risk sharing for the purchases by the ECB (8% of additional purchases) ; all additional purchases by the NCBs (80% of total additional purchases) will not be subject to risk sharing.

Timeframe of purchases? at least until end of September

Which maturities? Residual maturity f rom 2 to 30 years

Senior creditor status? No, purchases will be *pari passu* with other investors

Other measures: ECB removes 10 bp spread on the upcoming TLTROs

Is it credible? Let us first look at the positive facts. The ECB has seriously tried to deliver a significant QE programme today. There can be little doubt that in terms of size and pace, the ECB has impressed. With monthly purchases of €60 bn (including covered bonds and ABS purchases) at least until the end of September 2016, pointing to a €1.14 bn purchase programme, the ECB's version of QE was above market consensus, which expected a €550 bn programme according to a Bloomberg survey. As regards, the risk-sharing debate we are left with a stale flavour. However, we have never seen this to be a no go area for the ECB (see here) and we do not think that this will significantly dent investor confidence in the ECB's QE programme.

What is the markets' short-term reaction? Market reaction has been extremely positive with Government bond yields reaching new historical lows. Even Greek 10y is benefiting of the rally, down by 40pbs as Draghi said GGB might be included from July after the existing SMP redemptions. Obviously Agencies or ESM or EIB are outperforming but corporates are enjoying the ride as well. Without surprise EUR is lower breaking the 1.15 threshold and weaker even against emerging currencies (Turkish lira is up almost 2%, Zloty1%). Curve is bull flattening as the longer part is going to be concerned by the new purchase program

What impact on inflation and growth? Despite the markets' applause, we do not think that the ECB's QE programme will be a panacea for Eurozone's inflation. According to our estimates, it will eventually lift inflation by +0.2 to +0.4 percentage points in the next two years. So the Eurozone inflation rate could ideally stand at +1.7% at the end of 2016, which in fact would be pretty in line with the ECB's target of *"close but below 2%"*. Still, this outlook stands on shaky legs and clearly hinges on the further development in oil prices (see chart below). As far as growth is concerned, QE alone is not a significant game changer either. But once combined with the easing of the European budgetary rules announced last week by Brussels, it becomes definitely growth supportive. To put it simply, the ECB will buy sovereign bonds on the secondary market while governments will have more flexibility in creating public debt to finance investment through Juncker's newly created investment fund (EFSI). This turns Eurozone's policy mix into a very accommodative one, making economic agents richer than before (a sort of helicopter money "through the back door"). Definitely, this is good news for Eurozone growth, especially in 2016 when EFSI-financed investments will start bearing fruit.

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